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MUTUAL FUND SPOTLIGHT

Many Happy Returns

Stratton Growth Fund has displayed a disciplined approach to all-cap value investing that has outperformed for decades

BY KATHLEEN M. MCBRIDE

HEADING INTO THE NEXT QUARTER-century of Investment Advisor, *we wondered if there were any diversified equities funds that have been managed for 25 years or more by the same manager. While there is an elite group of portfolio managers with this kind of longevity, those with consistently good performance are extremely rare. One member of this exclusive club is James Stratton, chairman and CEO of Stratton Management Company in Plymouth Meeting, Pennsylvania. "Stratton Management manages around $2.3 billion all told, and mutual funds represent about $700 million of that; the rest are private accounts and institutional business," says Stratton, who founded the $167 million, no-load Stratton Growth Fund (STRGX) in 1972 and has managed it ever since. The fund boasts an average annual total return of 13.10% for the 25 years ended September 30, 2005.*

The fund has earned an overall four-star ranking from Standard & Poor's, with a 5-year average annual return of 13.07% versus 0.64% for its peers in the S&P 500 Index, and a three-year average annual return of 24.37% versus 12.09% for the S&P 500 Index.

Photography: Bill Cramer

What is your investment process? We are basically a value manager across the board—that's our style. We screen stocks; we have a complicated, quantitative computer formula; and we use value measures. About 70% of the formula is value measures—things like price/earnings, price/cash flow—interpreting whether stocks are cheap in general. The other 30% relates to earnings growth and price momentum to see whether the stocks are doing anything from an earnings and a price standpoint, because we just don't want to own a cheap stock that remains cheap, we want to own a cheap stock that looks like it can appreciate in value. We do that screen, and we rank them—this is something we do a little differently than others—by industry or major category sectors: all the energy stocks together, all the financials together. Then we rank them in order of their relative attraction, so we will always be looking at how they compare with other stocks in their sector. Then we start the actual stock selection process, looking at those that appear the most attractive and seeing if they qualify on basic fundamentals. We will not put more than 20% into a single sector.

I noticed in your top 10 holdings that energy was prominent. Energy right now [Dec. 9] is 18.5%— it's our leading sector. The second we call capital goods, at 12% to 13%, which are companies that would benefit from business spending, like Caterpillar Tractor (CAT) or Ingersoll-Rand (IR), or a more controversial one, Tyco (TYC)—the type of companies that build things for industry. Home builders are our third largest sector, where we have 11.5%, then insurance at 9%, and transportation at 9%. We're pretty well diversified among the sectors, but we are prepared to concentrate heavily in a sector we really like, and also avoid sectors that we don't like. Right now we don't own anything in the consumer staples area, and very little in the utility area. We have been of the belief that the economy is strong, revenues are strong, earnings are very strong, and we should be in the most rapidly growing areas of earnings growth during this expansion of our economy. It has worked out for us.

Your strategy has worked out for a long time, and looks very consistent. How do you achieve that? We have been doing the same thing—we have tweaked how we go about doing things—but we have not wobbled or ventured far from the path I described. Over the years, that's been very effective for us, with one two-year exception: 1998 and '99, when the value style was clearly out of favor, [during] the technology bubble. We were totally left behind in those two years. They were probably the worst years in my career. It was so persistent and it was so easy for people to make money in other areas that they almost felt like you were not necessary. For two years we seriously underperformed; when the crash came in 2000 that was wonderful for us because it put us back in the driver's seat in terms of what we were doing, and we've had very good performance for the last five years. The very nature of our style is such that if you ever get another bubble we're unlikely to participate; fortunately those things happen only about every 30 years.

Were '98 and '99 worse than 1973 to '75? In one way they were, because in the early '70s, the whole market went down, nobody made money, and while it was very painful because you were losing money for the fund or for clients, everybody else was losing money. In '98 and '99, we weren't losing money, we were actually just standing still, but everybody else was making a lot of money in Internet and biotech stocks. [Shareholders were] saying, "What's wrong with you? It's so easy to make money and you're not making it!" So psychologically, yes, '98 and '99 were worse than '72-'73. Neither are periods that I'd like to remember.

Yet you did well through the record high interest rates of the late '70s to early '80s, and were able to keep your consistent earnings power. Going back to how we manage the portfolio, we have about 46 stocks right now. Every quarter, as companies report, we are following their reporting, seeing whether they're delivering on the earnings, and to the extent that we have disappointments in earnings—especially in this sharply rising economy—we've been pretty brutal in getting rid of the weak sisters. Every quarter, two or three stocks get dropped from the portfolio because they failed to do what they said they were going to do, or what we thought they were going to do, and we then recycled that money into stocks that we think should do much better. I think if you maintain that discipline . . . if you pull the trigger every quarter on the real weak sisters in your portfolio, a) they're not there anymore, but b) you have money to invest in what look like the better ideas. It's a good discipline to have. Too many money managers hang onto the weak sisters hoping they'll come back; I think that's just wishful thinking.

Speaking of your longevity managing the fund (since 1972), how have you institutionalized management of the fund? First of all, there are about 30 people here, so it's a pretty decent-sized firm. We have an investment model portfolio committee that consists of seven people, senior portfolio managers here. We have about 10 portfolio managers at the firm, and seven of them are on this model committee. We meet every week to discuss ideas for our institutional model accounts, and they often find their way into the mutual fund. Or vice versa—we may pick up a stock in the mutual fund first, and then the more we learn about it the more appropriate it is for the institutional accounts. The areas [where we are] heavily weighted—energy and capital goods—those are in the institutional model as well. The difference with the [institutional] model is that it is a $5 billion market cap and up, so it's a large-cap value model. The Growth Fund is what we call multi cap, so it can own small cap and mid cap, but the bulk of it is in large cap.

Can you tell us about your largest holdings? Our largest holding hap-

pens to be in the energy area: Valero Energy (VLO) [3.5% of the portfolio as of November 30], a leading oil refining company that we've owned for quite a while. Our cost there is about $16 a share, and today it's about $106 a share, so we've had a very good run. We identified early the shortage of refining capacity, and the value of an oil refining company, and we made a commitment. We think the energy play is a long-term secular play, and yes, it can have its temporary ups and downs, but long term we haven't seen any new capacity coming along. Demand grows slowly, and we're likely to remain fairly fully invested or overweighted in energy. After that one, we have several other energy stocks; the third largest is a company called Penn Virginia (PVA), which is a combination natural gas and coal company that we bought at about $17; Its current price is around $60, so we have a quadruple in that. One of our biggest holdings that we've pared back but is still in our portfolio is PacifiCare Health Systems (PHS), a managed-care company that is being acquired by UnitedHealth Group (UNH). Now we're down to only 2% [in the portfolio], but we had more like 4%, and we had almost a ten-fold increase in value. The stock has moved up to a very full valuation. We took some profits this year, and we'll probably take the rest of the profits next year, and recycle that into other new ideas, but it's been a great success for us. We don't have any dominant company beyond that. There's a little bit here and there, but they're all value as we define them.

ABOUT THE MANAGER

VERY FEW PORTFOLIO MANAGERS HAVE RUN A MUTUAL FUND FOR AS long as James Stratton. In 1972, he founded the Stratton Growth Fund and Stratton Management Company, and has managed both ever since. Over the years, he added two other funds: Stratton Monthly Dividend REIT Shares, and Stratton Small-Cap Value Fund.

The chairman and CEO of Stratton Management, Stratton graduated from Penn State University with a B.S. in geophysics, and has an M.B.A. from Harvard Business School, where he was a Baker Scholar. Before founding Stratton Management, he was VP, director, and shareholder at Cooke & Bieler; managed investment advisory operations and equity-oriented profit sharing and pension portfolios at Drexel & Co., and was president and CEO of Drexel Firestone, Inc.

What about any stocks that didn't pan out the way you thought they would? We have a pretty harsh pattern of getting rid of the losers, so there aren't very many losses in this portfolio. Currently the worst stock in the portfolio is C&D Technologies (CHP), which we have 1% in, and it's been very disappointing. It's a company that made several acquisitions, and apparently bought a couple of companies where they didn't know what they were doing, and they dragged the whole company down. We have not eliminated that yet, but unless they turn the company around, it's certainly a candidate for elimination. We normally take our losses at the end of the tax year, to keep our capital gains down. We have $48 million of gains in the portfolio and $3 million of losses all told. We've been working hard to prune the losses as we get them, and keep the portfolio [invested] in the winners.

Where would this fund fit in an investor's portfolio? It's a good all-around fund because it's multi cap. We tend to get people who are probably more conservative. They want to be in equities, but don't want to take a high level of downside risk. If you look at our really long-term record, after all expenses—everything—[we've] been consistently in the 13.5% range, for 15 to 20 years. In my mind, [for] anybody who invests in equities long term, that's a pretty healthy return, and if they just are patient and sit there, they can do very well with the money.

Do you have a [core] percentage of the fund that you would recommend to advisors? I think it's presumptuous of me to tell advisors a percentage—they'll figure it out. The larger the portfolio, the more diversified it normally is, but for people who have limited resources I think that this could be a very high percentage of the portfolio because it's a relatively safe fund, with good diversification and performance.

What else should advisors know about the fund? There are no marketing fees, no 12b-1 fees, it's a 100% no-load fund and it's been that way all its life. I and other members of management have very large personal stakes in the fund; I probably am the largest single shareholder in the fund as an individual, and we have our money where our mouth is. If I were on the other side of the fence, I would be looking for people who have invested their own money in their fund and continue to do that, and certainly our profit-sharing plan here at the firm is 100% invested in our mutual funds—all three of them. The Growth Fund is the largest piece of that; it's roughly 50% of our profit-sharing assets. IA

Staff editor Kathleen M. McBride can be reached at kmcbride@investmentadvisor.com

STRATTON GROWTH FUND

800-472-4266 • www.strattonfunds.com

Ticker: STRGX
Manager: James W. Stratton
Manager's tenure: 1972
Fund started: September 1972
Min. initial investment: $2,000
Load (front-end): 0%
12(b)-1 fee: 0%
Net assets: $167 million
P/E ratio: 16.11
P/B ratio: 2.95
Median market cap: $9.57 billion
Expense ratio: 1.15%
Turnover: 44.44%
3-year alpha: 0.70
3-year beta: 1.14
3-year r-squared: 0.64
3-year stand. deviation: 14.63

RETURNS

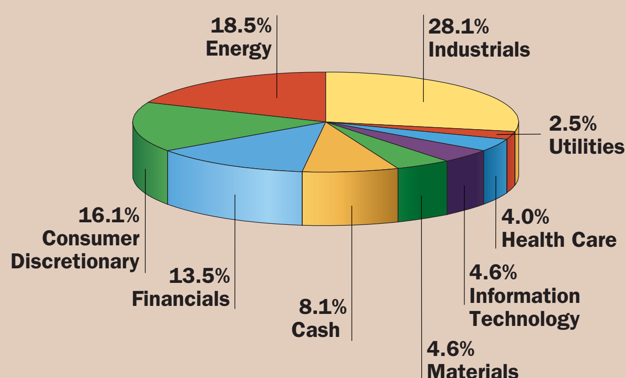
2004: 23.53%
2003: 42.19%
2002: -21.38%
12-month (annualized): 16.55%
3-year (annualized): 24.37%
5-year (annualized): 13.07%

TOP FIVE HOLDINGS

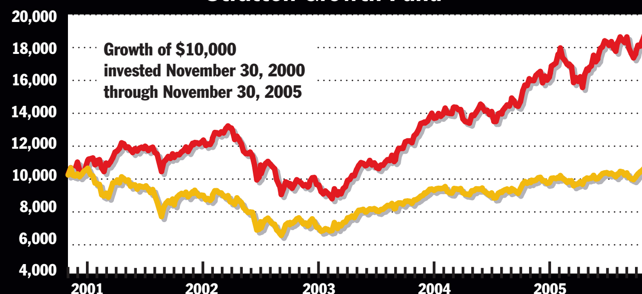
1. Valero Energy Corp.	3.5%
2. EOG Resources, Inc.	3.0%
3. Penn Virginia Corp.	2.9%
4. Lehman Bros. Holdings	2.6%
5. VF Corp.	2.5%

Sources: Standard & Poor's and Stratton Mutual Funds; data through 11/30/05

PORTFOLIO ALLOCATION



Stratton Growth Fund



	FINAL VALUE	CUMULATIVE TOTAL RETURN	AV. ANNUAL RETURN
Stratton Growth Fund	$18,480.38	+84.80%	+13.07%
S&P 500	$10,321.59	+3.22%	+0.64%

Source: Standard & Poor's

Performance through 12/31/05

Average Annual Returns

1 Year	+14.49%
5 Year	+11.74%
10 Year	+12.81%

The performance data quoted represents past performance, and is no guarantee of future results. Investment return and principal value will fluctuate so that an investor's shares, upon redemption, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. For performance data current to the most recent month-end, please visit www.strattonfunds.com

Stratton Growth Fund is actively managed, and the securities discussed in the article may not represent the current or future composition of the portfolio. The securities referenced in this article do not constitute investment advice and are not intended as recommendations to buy or sell any security. Investors should consult their investment professional regarding their individual investment program. Since the date of the article, economic factors, market conditions and the portfolio manager's views of the prospects of any particular investment may have changed.

You should consider the investment objectives, risks, charges and expenses of Stratton Growth Fund carefully before investing. A prospectus with this and other information about the fund may be obtained by calling 1-800-472-4266 or by visiting www.strattonfunds.com. The prospectus should be read carefully before investing.

Shares of Stratton Growth Fund are distributed by PFPC Distributors, Inc., 760 Moore Rd., King of Prussia, PA, 19406.

Stratton Growth Fund is ranked among 134 Equity All-Cap Value funds by S&P's three-year overall style rank of this fund. Funds are ranked on three year Sharpe Ratio. A Star ranking of 5 is assigned to the top 10% that also outperform their benchmark over 3 years. Approximately, the next 20% are ranked 4; 40% are ranked 3; 20% are ranked 2; 10% are ranked 1. For a fund to be ranked higher than 3 Stars, it must also outperform the three month Treasury bill over 3 years.

Definitions:

Standard deviation — A statistical measurement of distribution around an average, which depicts how widely returns varied over a certain period of time. Investors use the standard deviation of historical performance to try to predict the most likely range of returns.When a security has a high standard deviation, the predicted range of performance is wide, implying greater volatility.

R-squared— Shows the percentage of a security's performance that is explained by movement in the benchmark index. This shows the correlation between the fund and it's benchmark. An R-squared of 100% indicates that all movements of a fund can be explained by movements in the benchmark. A low R-squared indicates that very few of the security's movements can be explained by movements in its benchmark. An R-squared measure of 50%, for example, means that only 50% of the security's movements can be explained by movements in the benchmark index.

Alpha — A measure of a security's risk-adjusted performance. A positive value for alpha implies that the stock or mutual fund has performed better than expected based on its beta.

Beta— A quantitative measure of the volatility of a security, relative to the overall market or a particular benchmark. A beta greater than 1 means the security is more volatile than the general market, while a beta less than 1 is less volatile.

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